Chapter 1

Auto sector - Impact of slowdown on financial reporting

This article aims to:

Analyse main areas in relation to financial reporting where there could be an impact due to slowdown.

Introduction

The Indian as well as global automotive industry is in the midst of a slowdown. In the first nine months of financial year 2019-20, Passenger Vehicle (PV) sales in India declined by 17 per cent[1]. Thereby, impacting the cash position of component suppliers and putting their business sustainability at risk.

1. Article in Business Standard - 'Passenger Vehicles Sales Fall 16.40% in April-December 2019' published on 10 January 2020

The slowdown in the automobile sector in India can be attributed to factors like the general slowdown in the economy, the disruption caused by the private cab operators, difficulties in getting a loan for purchasing a car or two-wheeler, competition from electric vehicles in the coming years and the adoption of Bharat Stage (BS) VI emission standards.

While the economic cycle is blamed for the sliding sales globally, it is not the only reason. Europe's ban on diesel cars and the enforcement of safety norms across the world, global events like Brexit and US-China trade wars are factors too for the slowdown. As a result, major automobile companies are investing heavily on emerging technologies and alternative solutions to fuel. Besides, customers are waiting for better products amid the global transition to electric cars.

Many Original Equipment Manufacturers (OEMs) have announced production cuts over the past several months leading to cascading impact on the automobile ancillary units.

The automobile retail has witnessed around 200,000 job losses. A similar number is expected to have lost jobs in the ancillary industries[2].

2. Article in The Economic Times - 'Auto sector slowdown may wipe out a million jobs: SIAM' published on 5 September 2019

Impact of slowdown on financial statements of companies in automotive industry

We have analysed main financial reporting areas where there could be an impact due to slowdown.

Assessment of triggers for impairment

Due to continuous decline in sales and profitability over last few quarters, many OEMs have started assessing for triggers of impairment in accordance with Ind AS 36, *Impairment of Assets*. Due to the technological changes and stiff competition from other automotive players, there is a need to assess the recoverable amount of the assets.

Valuation of inventories

OEMs may have manufactured vehicles based on expected growth forecasts in the automotive industry which are lying as unsold stocks pertaining to BS IV emission levels. As the stock pertaining to BS IV compliant vehicles would not be usable post BS VI implementation, the OEMs would face challenge while valuing such unsold stocks and there could be huge increase in provisions of inventory.

Discounts and incentives to dealers

High stock levels with dealers forced OEMs to cut down on production. As dealers are also facing huge working capital issue, OEMs are offering discounts to end customers and incentives to dealers to increase sales. The OEMs should consider the impact of discounts and incentives on the measurement of revenue.

Provisions for contractually agreed terms

OEMs are largely dependent on their vendors for supply of materials required for production. They enter into contracts with vendors for purchase of certain minimum required quantities of materials based on the production plan and sales forecasts. In certain cases, they may have contractually agreed to reimburse certain amounts to vendors in the event they do not procure the materials as per the agreed terms.

Many OEMs have revised their production plans and sales forecasts due to the slowdown over last few months. Accordingly, they would need to assess the amount of provisions required for such commitments given to vendors as per contractually agreed terms.

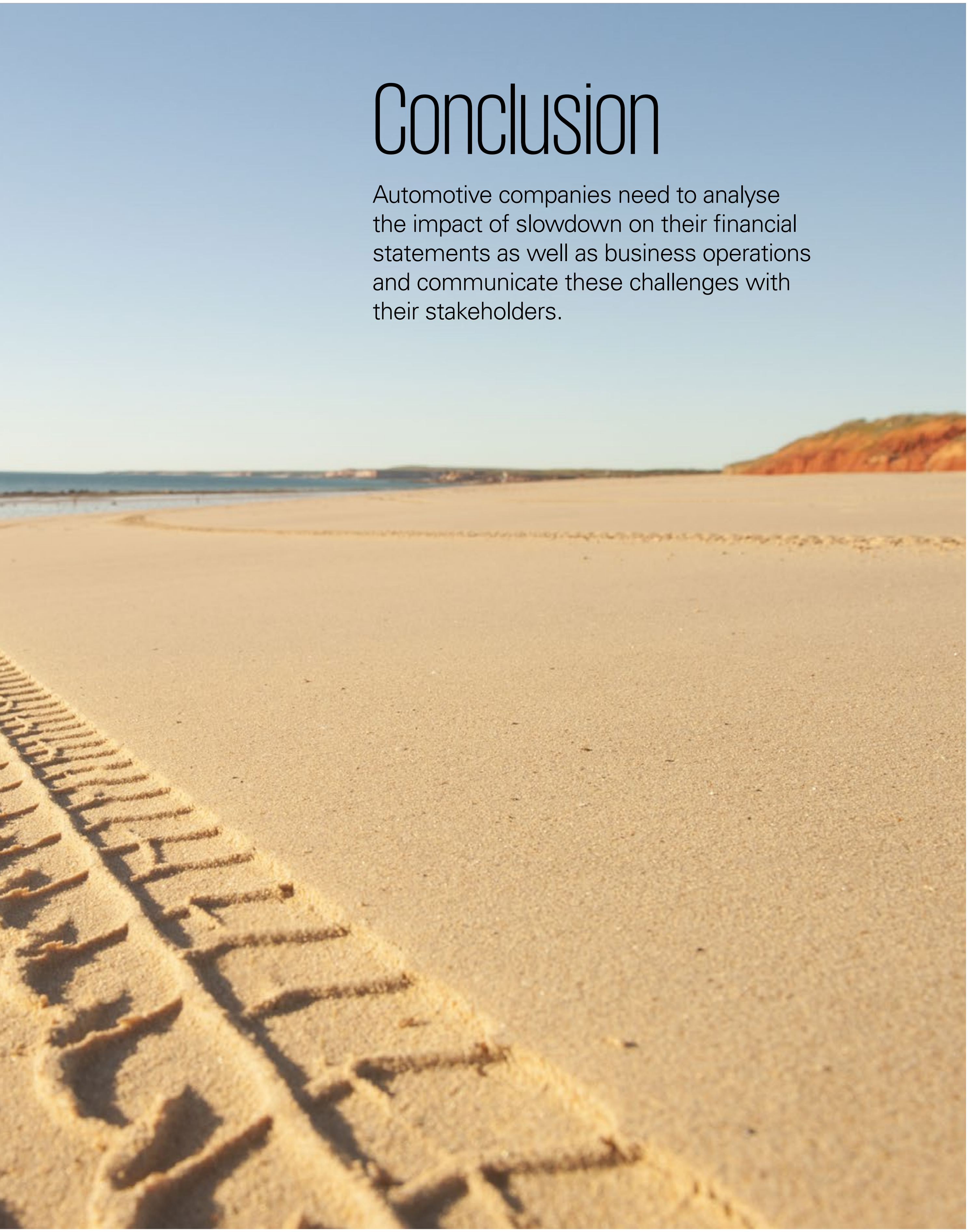
Employee layoffs and benefits reductions

Due to decline in business and slowdown, companies could consider reductions in employee benefits plans, performance pay/bonuses to employees and introduce Voluntary Retirement Schemes (VRS) as a cost control measure.

If VRS are rolled out, then entities would need to estimate accruals for compensation to be paid to employees under these schemes.

Working capital management

Slowdown in automotive sector is also impacting companies' working capital management and companies may face liquidity issues on account of increase in inventory levels, increase in receivable levels, decrease in cash flow levels, etc. Companies are expected to revisit their strategies for working capital management to reduce the borrowing costs and use own funds to maximum possible extent.



Conclusion

Automotive companies need to analyse the impact of slowdown on their financial statements as well as business operations and communicate these challenges with their stakeholders.